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No. 80

In the Supreme Court of the United States

OCTOBER TERM, 1958

THE MONTANA POWER COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

On Petition for a Writ of Certiorari to the United States Court of Claims

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINION BELOW

The opinion of the United States Court of Claims (Pet. 1a-7a) is reported at 159 F. Supp. 593.

JURISDICTION

The judgment of the United States Court of Claims was entered on March 5, 1958. (Pet. 1a, 7a.) The petition for a writ of certiorari was filed on June 2, 1958. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1255.

QUESTION PRESENTED

The taxpayer, a subsidiary corporation, issued $10,589,900 face amount of debentures in exchange for property of another subsidiary of the same parent

pursuant to a nontaxable reorganization. The inherited tax basis of the property was $7,044,544, but its fair market value was not shown. In a subsequent year, while it still held the property received in the reorganization, taxpayer retired the debentures by paying their face amount. The question is whether, as the Court of Claims held, taxpayer realized no deductible loss at the time it retired its debentures.

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(f) *Losses by Corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

STATEMENT

The facts as found by the Court of Claims (Pet. 7a-18a) may be summarized as follows:

American Power & Light Company (hereinafter referred to as American), a public utility holding company, acquired natural gas properties during the year 1931. The following year, these properties were transferred to Montana Power Gas Company (hereinafter referred to as Gas Company), an operating

company, in exchange for all of its outstanding stock. (Pet. 9a.)

In 1936, the Montana Power Company (hereinafter referred to as the taxpayer), acting under a plan of reorganization, issued its thirty-year five percent debentures to the Gas Company, in exchange for all of the latter's assets. The principal amount of the debentures was $10,589,900, and the adjusted basis of the assets for federal tax purposes was $7,044,544.44. On the date of the exchange, American, the parent company, owned 99.75 percent of the common stock and 93.73 percent of all of the outstanding voting stock of the taxpayer and 100 percent of the outstanding stock of the Gas Company. (Pet. 9a-10a.) Taxpayer keeps its books and reports its income on the accrual basis. (Pet. 13a.)

The issuance by the taxpayer of its debentures in exchange for the assets of Gas Company constituted a tax-free reorganization; as a consequence, the basis of the assets in the hands of the taxpayer was the adjusted basis which the assets had in the hands of Gas Company immediately prior to the exchange, or $7,044,544.44. This adjusted basis has been utilized by the taxpayer at all times subsequent to the exchange for all tax purposes. (Pet. 10a.)

In 1937, Gas Company was liquidated by its parent, American, in a transaction under which no gain or loss was recognized either to American or Gas Company. As a result, American acquired the $10,589,900 of five percent debentures from Gas Company, and the basis of the debentures in the hands of American was the same basis which the deben-

tures had in the hands of Gas Company immediately prior to the liquidation, $7,044,544.44. (Pet. 10a-11a.) In 1945, American sold the entire issue of debentures to two banks for a total cash consideration of $10,645,724.02. The gain upon such sale was not recognized because the sale was required under the provisions of the Public Utility Holding Company Act of 1935, c. 687, 49 Stat. 838 (15 U.S.C. 1952 ed., Section 79 *et seq.*) and thus fell within the provisions of Supplement R to the Internal Revenue Code of 1939. (Pet. 11a-13a.)

Thereafter, also in 1945, the taxpayer retired the $10,589,900 principal amount of its five percent debentures by paying cash in that amount to the banks. (Pet. 13a.)

In 1952, the taxpayer commenced an action in the United States District Court for the District of New Jersey against the United States, seeking a refund of income taxes for 1940 and of income and excess profits taxes for 1941. The refund was sought on the theory that the issuance of its debentures in 1936 to the Gas Company was made at a discount of $3,545,355.56, representing the excess of the principal amount of the debentures over the tax basis of the assets received in exchange. The taxpayer contended that it was entitled to amortize this discount ratably over the 30-year life of the debentures, and claimed a deduction from gross income of 1/30th of the aggregate discount for each of the taxable years. The District Court held that, in the absence of a showing that the fair market value of the property received by the taxpayer was less than the par value of the

bonds issued in exchange therefor, the bonds were not issued at a discount. (Pet. 14a.) See *Montana Power Co.* v. *United States*, 121 F. Supp. 577. This decision was affirmed by the Court of Appeals for the Third Circuit, sitting *en banc*, all the members of the court (except Chief Judge Biggs) agreeing that the taxpayer was not entitled to the bond discount deduction it sought in view of its failure to establish the fair market value of the property involved.[1] See 232 F. 2d 541. This Court denied certiorari, 352 U.S. 843. (Pet. 14a.)

After filing timely claims for refund, which were rejected, the taxpayer also brought the instant suit in the Court of Claims, seeking a refund of excess profits taxes for 1943 and 1944 and income taxes for 1945. (Pet. 7a-8a, 18a.) In its refund claims taxpayer contended that it was entitled to deductions in each of those years on account of amortization of discount on its debentures and, in addition, that allowance of the claimed deduction for 1945, the year the debentures were retired, would result in increased unused excess profits credits for 1943 and 1944. In the Court of Claims, the taxpayer contended that it suffered a loss in 1945, the year the

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[1] A concurring opinion by Judge Kalodner (concurred in by Judge Staley) expressed the view that the Treasury Regulations relating to bond discount are inapplicable to situations where bonds are issued in payment for property. Judge Kalodner's opinion also expressed the view (concurred in by Judges Staley and Hastie) that the Treasury Regulations relating to bond discount could not be invoked where there was no arm's length dealing between the seller and the purchaser. Chief Judge Biggs also wrote an opinion, dissenting in part and concurring in part.

debentures were retired, in the amount of the difference between the face value of the debentures and the tax basis of the assets received in exchange in 1936. (Pet. 1a, 4a.)

The Court of Claims, sustaining the Commissioner's determination, held that the taxpayer did not realize any loss in 1945 by reason of retirement of the debentures, and accordingly ordered dismissal of the taxpayer's petition. (Pet. 4a-7a.)[2]

ARGUMENT

This case involves the same transaction, and essentially the same question, as was presented in *Montana Power Co.* v. *United States*, 232 F. 2d 541 (C.A. 3d), certiorari denied, 352 U.S. 843. There, the taxpayer sought to deduct the difference between the face amount of the debentures and the tax basis of the property received in the tax-free exchange as bond discount amortizable over the 30-year life of the debentures. Here, instead of attempting to spread and deduct the difference over the life of the debentures in the form of annual amortization of bond discount, taxpayer seeks to deduct, in the guise of a "loss", the entire difference in the year in which it paid the face amount of the debentures, and thus in

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[2] The Government alternatively urged below (1) that taxpayer's contention that it was entitled to a loss deduction in 1945, under Section 23(f) of the Internal Revenue Code of 1939, *supra*, was not properly raised in the claim for refund or the petition in the Court of Claims; and (2) collateral estoppel, based upon the decision in the prior litigation. The Court of Claims deemed it unnecessary to pass upon these defenses, and the Government wishes to preserve them in the event certiorari is granted.

effect obtain in a lump sum and in a later year the same deductions which were disallowed for the earlier year. In denying the claimed loss deduction the court below reached the same result as did the Third Circuit in the prior case, and nothing has occurred since the denial of certiorari in that case which warrants further review of this one. Indeed, the lone case (*American Smelting & Refining Co.* v. *United States*, 130 F. 2d 883 (C.A. 3d)) with which the taxpayer asserts the decision below is "directly" in conflict (Pet. 6-7) was decided by the same court which in the *Montana Power* case rejected the taxpayer's contentions with respect to the very transaction here involved—contentions basically the same as those now advanced—and whose ruling this Court declined to review.

1. The decision of the Court of Claims is clearly correct. In 1936, the taxpayer, in a statutory reorganization,[3] exchanged its debentures, with a par value of $10,589,900, for the property of the Gas Company (another subsidiary of its parent corporation) having an adjusted basis, for tax purposes, of $7,044,544.44. No gain or loss was recognized on the transaction;[4] as a consequence, the Gas Company's tax basis for the bonds acquired was the same as that of the property given in exchange, and the taxpayer's tax basis for the property it acquired was the same as it was in the hands of the Gas Com-

[3] The reorganization was pursuant to Section 112 (g) (1) (C) of the Revenue Act of 1936, c. 690, 49 Stat. 1648.

[4] Section 112(b) (4) of the Revenue Act of 1936, *supra*.

pany.[5] (Pet. 9a-10a.) In 1945, the taxpayer retired the debentures by paying the principal amount to the holders. (Pet. 13a.)

The effect of the statutory provision that the taxpayer use as its basis for the property acquired in exchange for the debentures the basis which the property had in the hands of the transferor Gas Company is to require the transferee taxpayer to take the property subject to the potential realization of the gain to the transferor which escaped recognition in 1936 because of its transfer pursuant to a tax-free reorganization. That gain consisted of the excess of the par value of the debentures ($10,589,900) over the adjusted basis of the property exchanged ($7,044,544.44).[6] It is precisely that unrecognized gain which the taxpayer here seeks to treat as a deductible loss for 1945 by reason of having paid the par value of the debentures. The allowance of the claimed loss would defeat the Congressional design in requiring the taxpayer-transferee to carry over as its basis for the property received on the tax-free exchange the basis of its transferor, the Gas Company. As the court below pointed out (Pet. 4a-6a), when the taxpayer sells or otherwise disposes of the property it will realize recognizable gain or loss measured by the difference between the amount received and the tax basis of the property. Concededly, however, no disposition of the property occurred in the taxable year.

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[5] Sections 113(a)(6) and (7) of the Revenue Act of 1936, *supra*.

[6] Section 111(a) of the Revenue Act of 1936, *supra*.

The court below properly rejected the taxpayer's contention that it is entitled to deduct as a "loss" in 1945 the difference between the amount paid (par value) to retire the debentures and the inherited tax basis of the property received on the 1936 tax-free exchange. Only losses actually sustained are deductible (Sec. 23(f) of the Internal Revenue Code of 1939, *supra*, p. 2; *United States* v. *White Dental* Mfg. Co., 274 U.S. 398, 401; *Weiss* v. *Wiener*, 279 U.S. 333, 335), and no economic gain or loss is realized when a taxpayer satisfies an indebtedness by payment of the exact amount owed (*United States* v. *Kirby Lumber Co.*, 284 U.S. 1; *Helvering* v. *American Chicle Co.*, 291 U.S. 426).

2. There is no merit in taxpayer's contention (Pet. 6, 9-15) that the decision below conflicts with the principles enunciated by this Court in *United States* v. *Kirby*, *supra*; *Helvering* v. *American Chicle Co.*, *supra*, and like cases.[7] Those cases involved an entirely different type of transaction, and a question far removed from that here presented. There, the taxpayer discharged bond indebtedness by a payment of *less* than the face amount of the debt and it was held that the resulting increase in its net worth represented gain includable in gross income. Here, the taxpayer retired its debenture indebtedness by paying the *face* amount, not a different amount. Accordingly, its cash was reduced in the same amount that its outstanding debenture liability was reduced,

[7] See *Commissioner* v. *Jacobson*, 336 U.S. 28; *Helvering* v. *American Dental Co.*, 318 U.S. 322; *Claridge Apartments Co.* v. *Commissioner*, 323 U.S. 141.

and its net worth was neither increased nor decreased.

Even assuming, as taxpayer implies, that a debtor's net worth is affected by the mere issuance of a debt instrument in an amount different from the basis of the property received in exchange, the gain or loss would be realized in the year the debt was incurred (here, 1936), not the year it was paid (here, 1945). The court below understandably encountered "difficulty" in "relating the plaintiff's alleged diminished net worth to the year 1945." (Pet. 5a.)

Taxpayer's contention that it sustained a loss in 1945 (by reason of issuance of the debentures in 1936 for a consideration allegedly less than par value) rests on the additional assumption (Pet. 10) that the consideration received for the debentures is to be measured by the tax basis of the property acquired in exchange, rather than the fair market value. The settled rule is to the contrary. See *Montana Power Co. v. United States, supra; American Smelting Co.* v. *United States, supra; Dodge Bros., Inc.* v. *United States*, 118 F. 2d 95 (C.A. 4th); *Arkansas-Missouri Power Corp.* v. *Paschal*, 243 F. 2d 584 (C.A. 8th), certiorari denied, 355 U.S. 835; *Sacramento Medico Dental Building Co.* v. *Commissioner*, 47 B.T.A. 315, 329.

3. Contrary to taxpayer's assertion (Pet. 6-8), the decision below is not in conflict with *American Smelting & Refining Co.* v. *United States*, 130 F. 2d 883 (C.A. 3d). That case dealt with amortization of bond discount over the life of the bonds, and it was

there held that (1) annual deductions for bond discount are in the nature of deductions for additional "interest"; (2) irrespective of whether bonds are issued for cash or property, the amount of the discount amortizable is the difference between the par value of the bonds and the consideration received; and (3) the bonds there having been issued for property (preferred stock), the consideration received was to be measured by the fair market value of the property. See also *Helvering* v. *Union Pacific R. Co.*, 293 U.S. 282. In the instant case, the taxpayer is not only seeking to deduct as a "loss" in the year the debentures were retired the entire difference between the par value of the debentures and the consideration initially received upon their issuance; it is also seeking, in derogation of the holding in the *American Smelting* case, to equate the consideration received with the tax basis, rather than with the fair market value of the property. While the court below indicated disagreement with the decision in *American Smelting*, it did so on the hypothesis that the fair market value of the assets received by taxpayer was less than the face value of the debentures. (Pet. 6a.) Significantly, no claim is or can be made here that the fair market value of the property received by taxpayer in exchange for the debentures—as distinguished from the transferor Gas Company's tax basis which taxpayer was required to use by reason of the nontaxable nature of the exchange—was less than the face value of the debentures. In any event, as already noted, the same court which decided the *American Smelting* case subsequently de-

cided the *Montana Power* case, wherein it denied claimed bond discount deductions with respect to the very debentures here involved, and the decision below is clearly in accord with the latter decision.

4. No issue of general importance is raised by the decision below. Taxpayer's assertion (Pet. 6, 15-16) that an important question is presented rests, in the final analysis, upon nothing more than its unfounded claim of conflict with the principles enunciated by this Court in the *Kirby Lumber* and similar cases.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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